LG&E ENERGY

October 15, 2003

LG&E Energy Corp.
220 West Main Street (40202)
P.O. Box 32030
Louisville, Kentucky 40232

Mr. Thomas Dorman, Executive Director
Public Service Commission
211 Sower Boulevard
P. O. Box 615
Frankfort, Kentucky 40602

RE: ***AN INVESTIGATION PURSUANT TO KRS 278.260 OF THE EARNINGS SHARING MECHANISM TARIFF OF KENTUCKY UTILITIES COMPANY***
CASE NO. 2003-00334
AND
AN INVESTIGATION PURSUANT TO KRS 278.260 OF THE EARNINGS SHARING MECHANISM TARIFF OF LOUISVILLE GAS AND ELECTRIC COMPANY
CASE NO. 2003-00335

Dear Mr. Dorman:

Pursuant to the schedule established by the Kentucky Public Service Commission in its order dated September 12, 2003, in the above-referenced docket, enclosed please find an original and ten (10) copies of the direct testimony of (i) S. Bradford Rives, (ii) Paula H. Pottinger, Ph.D., (iii) Valerie L. Scott, (iv) Richard F. Meischeid, (v) Michael S. Beer, submitted on behalf of Kentucky Utilities and Louisville Gas and Electric Company.

Please confirm your receipt of this filing by placing the stamp of your office with the date of October 15, 2003 on the first page of the extra copy enclosed, and return the extra copy to me in the enclosed self-addressed, stamped envelope.

Should you have any questions regarding the enclosed, please do not hesitate to contact me directly at 502/627-4110.

Sincerely,

John Wolfram
Manager, Regulatory Policy/Strategy

Cc (w/enclosures): All Parties on Service List

S. Bradford Rives
Testimony

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INVESTIGATION PURSUANT TO KRS 278.260 OF THE EARNINGS SHARING MECHANISM TARIFF OF KENTUCKY UTILITIES COMPANY	))))	CASE NO. 2003-00334

AND

AN INVESTIGATION PURSUANT TO KRS 278.260 OF THE EARNINGS SHARING MECHANISM TARIFF OF LOUISVILLE GAS AND ELECTRIC COMPANY	))))	CASE NO. 2003-00335

TESTIMONY OF
S. BRADFORD RIVES
CHIEF FINANCIAL OFFICER
LG&E ENERGY CORP.

Filed: October 15, 2003

Q. Please state your name, position and business address.

A. My name is S. Bradford Rives. I am Chief Financial Officer, LG&E Energy Corp. My business address is 220 West Main Street, Louisville, Kentucky. A statement of my qualification is attached as Appendix A.

Q. Have you previously testified before this Commission?

A. Yes. I previously testified before this Commission in rate proceedings, administrative investigations and environmental surcharge proceedings, on behalf of LG&E Energy Corp.'s regulated utility subsidiaries, Louisville Gas and Electric Company ("LG&E") and Kentucky Utilities Company ("KU") (collectively referred to as "Companies").

Q. What is the purpose of your testimony?

A. I will summarize the Companies' position as to the effectiveness of the Earnings Sharing Mechanism ("ESM") to date, and will present generally the Companies' response to the recommendations made in the audit report ("Report") submitted by the Barrington-Wellesley Group, Inc. ("Auditors") in this proceeding on August 29, 2003. Those recommendations with which the Companies take exception are addressed in detail by other witness, as noted herein.

Q. Has the ESM satisfied the objectives for which it was originally adopted?

A. Yes. As the Commission is aware, LG&E and KU historically have operated to a world-class standard of excellence, providing their customers outstanding value in retail electric service through a combination of low rates and exceptional service. In fact, the Companies' service ranked among the best utilities nationwide again this year, as measured by J.D. Power & Associates, an international marketing information firm. In light of the Companies' already low rates and high customer satisfaction, the ESM has not created a new corporate mindset, but rather has served to re-enforce existing corporate efficiency incentives. At the same time, the ESM has provided a means of mitigating the effects of over- and under-earnings, thereby providing an appropriate balance between the interests of shareholders and ratepayers as envisioned by the Commission in its orders adopting the ESM. That the ESM has served its purpose in this regard is evident by the fact that the Companies returned $1.5 million to customers in 2001 and 2002, with respect to the 2000 and 2001 operating periods, respectively. Although customers are contributing an additional $24 million in 2003 as a result of a shortfall in allowed earnings in 2002 (as measured from the lower end of the ESM deadband), it is important to note that the Companies are bearing $36 million of this earnings shortfall, demonstrating the balance of interests achieved through the ESM mechanism as currently structured.

Q. Does the Report support the Companies' belief that they currently operate to a world-class standard of excellence?

A. Yes. After several weeks of investigation, the Auditors confirmed that the Companies are well-run utilities that remain dedicated to achieving optimal performance and customer value:

> [The Auditors] found LG&E and KU to be well-managed utilities with a strong management team in place. The Companies have sound planning, budgeting and accounting processes and good expenditure control. The Companies have participated in numerous process improvement changes over the past several years including during the trial ESM period (2000-2002). These changes include implementing a shift towards a reliability-centered asset management program, a variable workforce, and an economic/risk-based budgeting process . . . The Companies' position is that while these changes have not been driven as a result of ESM, ESM reinforces their existing corporate structure of performance improvement. The Companies have generally maintained, and in some cases improved,

already high levels of service reliability and customer satisfaction during the trial period. (Report at I-2, I-3.)

The Companies are pleased that the Auditors recognize their strengths and accomplishments, and agree with much of what the Auditors present in their Report, including the following:

- "Continuous improvement programs were in place before and during the ESM pilot period (2000-2002) and the Companies have undertaken many initiatives to reduce costs" (Report at I-19);
- "The ESM does accomplish the objectives stated in the [Performance Based Ratemaking] orders [Case Nos. 98-474, 98-426]" (Report at I-19);
- "The ESM provides incentives to increase efficiency" (Report at I-19);
- "Operating and capital budgeting processes are effective and have been enhanced in recent years as part of the VDT [Value Delivery Team] emphasis on asset lifecycle costs and benefits . . ." (Report at I-20);
- "The system of internal controls related to the appropriate accounting for expenditures as either capital, expense, or deferred is adequate and appears to be operating effectively" (Report at I-21);
- "The Companies place considerable emphasis on service levels, customer satisfaction, and safety as part of the planning budgeting, capital expenditure, and performance monitoring activities" (Report at I-21);
- "The Companies have, in most instances, maintained or improved distribution reliability levels over pre-ESM period levels" (Report at I-21);

- The Companies have maintained top-quartile performance levels in both reliability and safety as measured by several well-recognized industry benchmarking surveys" (Report at I-21);
- "Retail business unit performance levels improved in 2002 over the previous year and are tracking at higher levels in early year-to-date reports for 2003" (Report at I-21); and
- "Preliminary review of 2003 storm recovery effort indicates that this storm was out of the ordinary and that the recovery was well managed" (Report at I-21).

There are particular recommendations, however, with which the Companies do take exception. In fact, with respect to certain issues, the Auditors have proposed solutions to problems that simply do not exist.

Q. Turning to the Auditors' recommendations, please identify generally each recommendation and summarize the Companies' response.

A. With respect to *Audit Area of Inquiry No. 1* (Affiliate Transactions), the Auditors make the following recommendations:

1. Make a single executive without conflicts of interest responsible for the integrity of the Kentucky regulated Companies.
2. Enhance internal audit resources dedicated to regulated activities.
3. Utilize service level agreements according to the spirit of the concept.

For the reasons set forth in the testimonies of Valerie L. Scott and Paula S. Pottinger, the Companies disagree strongly with Recommendation No. 1. Regarding Recommendation Nos. 2 and 3, the Companies have agreed to implement meaningful changes to protocol that they believe will fully resolve the Auditors' concerns, including the commencement of annual internal audits of all service level agreements, and the designation of a single executive responsible for ensuring that the audit and certification processes are completed as described herein. These changes are discussed in greater detail in the testimonies of Ms. Scott and Dr. Pottinger.

With regard to *Audit Area of Inquiry No. 2* (Management Practices), the Auditors make the following major recommendation:

> Directly link the Companies' executive short-term incentive program to the ESM. Senior executives responsible for any part of LG&E/KU's operation or administration should have a meaningful portion of their short-term incentive opportunities linked to the two utility operating Companies meeting and exceeding their allowed rates of return. The incentive would be reduced if the allowed rate of return is not achieved.

In responses to data requests submitted after the Report was filed, the Auditors expanded the scope of the proposed ESM "link" to include the Companies' executive long-term incentive program. LG&E and KU strongly object to creating any linkage between the Companies' incentive compensation programs and the ESM. For the reasons discussed in Ms. Pottinger's testimony, the testimony of Richard F. Meischeid, Principal, Towers Perrin, and Mr. Michael S. Beer, Vice- President, Rates and Regulatory, LG&E Energy Corp. such linkage is not only unnecessary and entirely inappropriate, it also runs directly counter to the ultimate objectives of the ESM.

With regard to *Audit Area of Inquiry Nos. 3, 4* (ESM Structure), the Auditors make the following major recommendation:

> The Commission should implement a multi-year ESM based on the current ESM format. Timing issues represent a significant weakness because they may encourage the companies to shift costs between accounting periods in order to invoke an ESM factor revenue adjustment.

LG&E and KU object to implementation of a multi-year year ESM. As discussed in the testimony of Michael S. Beer, the behavior that the Auditors propose to remedy through a multi-year ESM (of which the Auditors admit there is no evidence to date) simply cannot occur given the extensive regulatory scrutiny the Companies currently undergo.

The remaining recommendations made by the Auditors in Audit Area of Inquiry No. 3, as set forth on page I-23, are acceptable to the Companies. These issues are likewise addressed more fully in Mr. Beer's testimony.

Regarding *Audit Area of Inquiry Nos. 5-7* (Budgeting, Accounting, Reliability Service Levels), the Companies accept the recommendations made by Auditors.

Q. Do LG&E and KU have a recommendation for the Commission?

A. Yes. The Commission should extend the ESM as proposed by the Companies. The Commission should reject the recommendations of BWG to modify the ESM's structure to create a multi-year construct, to realign the Companies' executive management structure, and to directly link the Executive Short-Term Incentive Compensation Plan to ESM.

Q. Does this conclude your testimony?

A. Yes.

VERIFICATION

COMMONWEALTH OF KENTUCKY)
)
COUNTY OF JEFFERSON)

The undersigned, **S. Bradford Rives**, being duly sworn, deposes and states that he is Chief Financial Officer for LG&E Energy Services Inc., that he has personal knowledge of the matters set forth in the foregoing testimony and exhibits, and the answers contained therein are true and correct to the best of his information, knowledge and belief.

S B Rives
S. BRADFORD RIVES

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 15th day of October, 2003.

Carol A. Hardison (SEAL)
Notary Public

My Commission Expires:

August 5, 2004

APPENDIX A

S. Bradford Rives

Senior Vice President, Finance and Controller
LG&E Energy Corp.
220 West Main Street
Louisville, Kentucky 40202
(502) 627-3990

Civic Activities

African - American Venture Capital Fund – Member, Investment Committee
Lincoln Heritage Council, Boy Scouts of America – Executive Board
National Kidney Foundation of Kentucky – Co-Chair
St. Margaret Mary Parish

Professional/Trade Memberships

American Institute of Certified Public Accountants (AICPA)
Financial Executives Institute
Kentucky Bar Association
Kentucky Society of Certified Public Accountants
Louisville Bar Association

Education

University of Louisville School of Law, J.D. (cum laude) -- 1988
University of Kentucky, B.S. in Accounting -- 1980

Previous Positions

LG&E Energy Corp., Louisville, KY
Feb 1999 - Dec 2000 – Senior Vice President, Finance and Business Development
Mar 1996 - Feb 1999 – Vice President, Finance and Controller
Jan 1996 - Mar 1996 – Vice President, Finance, Non Utility Business
Mar 1995 - Dec 1995 – Vice President, Controller and Treasurer (LG&E Power)
Jun 1994 - Mar 1995 – Vice President and Treasurer (LG&E Power)
Jan 1994 - Jun 1994 – Associate General Counsel
Jan 1993 - Dec 1993 – Director, Business Development
Feb 1992 - Dec 1992 – Assistant Treasurer
Oct 1991 - Feb 1992 – Director, Corporate Finance

Louisville Gas and Electric Company, Louisville, KY
1990-1991 -- Director, Corporate Finance
1989-1990 -- Director, Corporate Tax
1985-1989 -- Manager, Tax Accounting
1983-1985 -- Assistant Manager, Tax Accounting

Arthur Andersen and Company, Louisville, KY
1982-1983 -- Audit Senior
1980-1982 -- Audit Staff

Paula H. Pottinger, Ph.D.
Testimony

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INVESTIGATION PURSUANT TO KRS 278.260 OF THE EARNINGS SHARING MECHANISM TARIFF OF KENTUCKY UTILITIES COMPANY	))))	CASE NO. 2003-00334

AND

AN INVESTIGATION PURSUANT TO KRS 278.260 OF THE EARNINGS SHARING MECHANISM TARIFF OF LOUISVILLE GAS AND ELECTRIC COMPANY	))))	CASE NO. 2003-00335

TESTIMONY OF
DR. PAULA H. POTTINGER
VICE PRESIDENT, HUMAN RESOURCES
LG&E ENERGY CORP.

Filed: October 15, 2003

Q. Please state your name, position and business address.

A. My name is Paula H. Pottinger, Ph.D. I am the Vice President, Human Resources for LG&E Energy Corp. My business address is 220 West Main Street, Louisville, Kentucky 40202. A statement of my qualifications is attached as Appendix A.

Q. What are your duties and responsibilities as Vice President, Human Resources?

A. I am responsible for the planning, design, development, and implementation of all of the human resource programs and policies of LG&E Energy Corp. ("LG&E Energy"). This responsibility includes compensation and benefits, employee and labor relations, safety and loss prevention, staffing and development, and employee health services.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to demonstrate that the executive short-term incentive compensation program currently administered by LG&E Energy is effective as presently designed and to specifically respond to two of the recommendations contained in the Final Report ("Report") on the focused management audit of the Earnings Sharing Mechanisms ("ESM") of Louisville Gas and Electric Company ("LG&E") and Kentucky Utilities Company ("KU"). This Report was issued by the Barrington-Wellesley Group ("BWG") on August 31, 2003.

Q. Do LG&E and KU agree with the BWG recommendation to "directly link the executive short-term incentive program to the ESM?"

A. No. Although there is much in the Report with which LG&E and KU agree, certain recommendations contained therein are objectionable. BWG has, for example, recommended substantial changes to the executive short-term incentive compensation plan of LG&E and KU without any evidence of wrongdoing or harm that needs to be redressed. Although BWG did not find any evidence of inappropriate conduct on the part of the management of LG&E and KU, and was unable to identify even a single instance where their existing structure has inured to the detriment of LG&E, KU, or their customers, BWG continues to encourage substantial changes in the way LG&E and KU compensate their executives and otherwise conduct their business. More importantly, BWG has not supported its recommendation with any evidence of reduced costs or resulting benefit to LG&E's and KU's customers and, in fact, noted in response to Data Request Question No. 10 that the gathering of such evidence was not within the scope of the audit. Thus, these recommendations are based only on speculation and address problems that simply do not exist. The recommendation of BWG to directly link the short-term executive incentive compensation plan to LG&E's and KU's ESM should be rejected.

Q. **Please describe the executive compensation program currently administered by LG&E Energy.**

A. LG&E Energy compensates its executives through a mix of fixed and variable pay. The short-term and long-term incentive compensation plans constitute the variable pay. LG&E Energy determines the salaries of its executives by referencing the market for base, total cash compensation and total direct compensation. In order to provide an independent external market pricing evaluation of executive compensation, LG&E Energy engages Towers Perrin annually to match executive positions to benchmark positions within the general and energy industries. Executive base compensation is reviewed and updated based upon the recommendation of the Chief Executive Officer, after referencing market data, overall projected market increases and budget parameters.

Adjustments to short-term and long-term incentive compensation target percents are reviewed annually as after referencing market data as well.

Q. What general compensation principles do LG&E and KU employ when determining executive incentive compensation?

A. LG&E Energy's incentive compensation program compensates its executives in a manner that is timely, equitable, cost-effective, and competitive with practices in comparable labor markets. The incentive program focuses key employees on the achievement of business objectives. This serves as a guiding principle in designing and implementing our compensation programs. Our ability to design innovative and flexible compensation programs within the overall context of reasonable total pay levels is critical to the LG&E Energy's continued success in achieving business goals and objectives by meeting customer needs reliably at the lowest possible cost.

Q. What is the purpose of LG&E Energy's Executive Short-Term Incentive Compensation Plan?

A. The Executive Short-Term Incentive Compensation Plan ("ESTICP") is designed to provide senior executives of LG&E Energy and its subsidiaries with a meaningful annual incentive opportunity based upon the achievement of specific corporate, business unit, and individual goals. Corporate, business unit, and individual goals and targets are established annually. Periodically, corporate and business unit updates are provided to communicate to executives performance against targets. Mid-year discussions are also held to review individual goals.

Q. What is the purpose of the long-term incentive compensation plan?

A. The purpose of the long-term plan is to promote the success of LG&E Energy and its subsidiaries by providing incentives to key employees that will link their personal interests in the long-term financial success of LG&E Energy and its subsidiaries and to growth in the parent company's shareholder value. The long-term plan provides increased flexibility to LG&E Energy to motivate, attract, and retain key employees who help lead the successful performance of their operations. These long-term measures and targets are also established annually.

Q. Isn't the executive short-term incentive plan really just another name for a "bonus"?

A. No! There are two primary differences between bonuses and incentives: (1) Incentives are normally a mechanism for delivering a portion of what is thought to be an appropriate amount of pay for the job and, as such, are normally a substitute for a portion of the salary that would otherwise be paid. Bonuses, on the other hand, are normally paid in addition to the normal compensation for the job. (2) While incentives are normally tied to pre-established performance goals or standards that define how much will be paid for a given performance outcome, bonuses are typically discretionary, after-the-fact payments intended to communicate thanks for a job well done.

Q. What are the advantages to incentives versus bonuses?

A. Incentives have the potential to more positively affect performance because they can be used to focus attention and communicate priorities. Incentives act to lower fixed costs when performance falls below standard whereas bonuses can only increase costs since they are an add-on to normal compensation. Additionally, when well designed, incentives are viewed more positively by employees because they know what they need to do to increase their compensation. With bonuses, rewards can be perceived as arbitrary and may be more a function of the Company's ability to afford them than the employees having performed sufficiently to deserve them.

Q. Do you agree with the finding of BWG at page IV-4, Item 3, of the Report that the executive short-term incentive compensation program is not adequately in alignment with LG&E's and KU's ESM programs?

A. Absolutely not. At page IV-5 of its Report, BWG criticizes the ESTICP because it is "based on performance against goals, not absolute operating company rate of return." The fact that the ESTICP is based on performance against goals instead of absolute operating company rate of return is completely consistent with the objective and purpose of the ESM. Measuring performance against the achievement of goals is an entirely appropriate human resource tool and completely consistent with the goal of the ESM for providing incentives to increase performance. The objective of measuring the performance of an executive against the achievement of the budget goals as well as performance goals that are intended to improve the customer service, satisfaction and reliability is in alignment with the objectives of the ESM.

BWG's Report found no evidence that LG&E Energy set its budgeted internal operating profit low in order to manipulate the compensation system. See Response to Data Request No. 40.

The Report cites the incentive payments in 2002 and implies that the payments in that year are an example of the BWG's criticism. BWG's implication is unfair and not accurate. Such criticism is completely unrealistic given the acquisitions of LG&E Energy first by Powergen and then by E.ON AG. Payouts in 2002 cannot be considered a typical example of how incentives are likely to be paid on a prospective basis because of the impact of the E.ON AG merger. Through discovery, BWG conceded this point. (Response to Data Request No. 41). BWG acknowledged through discovery that it had no evidence that the 2002 corporate objectives were set, much less deliberately set, low for 2002. (Response to Data Request No. 40).

Q. What is the impact if the Commission were to accept BWG's recommendation?

A. This proposal, if implemented, would require the Commission to substitute its own judgment for that of the management of LG&E and KU and would violate the long-standing compact between utilities and regulators to allow utility managers to make their own business decisions. By continuously respecting this compact, utility customers and investors have been well-served. Regulatory commissions must continue to focus on the regulation of the rates and services of utilities. Utility managers must continue to have the ability to manage the utility as they determine to be appropriate and make sound business decisions based on their demonstrated expertise and experience. To do otherwise would not only damage investor confidence, but could ultimately harm customers as well by removing from management the ability to make day-to-day business decisions.

LG&E and KU strongly believe that their employees are fundamental to their overall success. In order to preserve these human resource assets, management relies heavily on its compensation programs. If the design and management of the compensation programs is taken away from the management of LG&E and KU, the task of attracting and retaining valuable employees will become the responsibility of the regulator with uncertain consequences at best. Such action would be particularly egregious due to the fact that the costs associated with LG&E's and KU's incentive compensation plans are not paid by their customers.

Q. Is it reasonable for the Commission to link the results of LG&E's and KU's ESM directly to the ESTICP?

A. No. This recommendation ignores the fact that LG&E's and KU's executive compensation program and their ESM's are fundamentally different in design and purpose. The short-term incentive plan is a human resources tool designed to attract, motivate and retain highly qualified personnel by fairly compensating employees based upon known and measurable performance targets specific to their respective business units and are comparable to other employers in the industry. By contrast, the ESM mechanism is not intended to serve as a performance rating criterion for each employee. Rather, the primary purpose of LG&E's and KU's ESM is to mitigate the effects associated with over- and under-earnings by serving as a measure of whether the utilities are recovering too much or too little from their customers for the services they receive.

Because of these differences, it is unreasonable to link LG&E's and KU's executive short term incentive compensation to their ESM results. By creating such a link, each executive's short term compensation level would be tied to events that may be entirely outside of his or her control. For example, if LG&E or KU experience one or more severe ice storms in the course of a year, the associated restoration costs that are not recovered under an insurance policy could drop the utilities' earnings below the deadband. Strict application of an ESM-based methodology under these circumstances would substantially reduce, if not eliminate, any incentive compensation despite superior restoration efforts and only penalize the executives.

The fact that abnormal ice storms can increase a utility's cost of service in a given year bears absolutely no relationship to management's performance. Incentives should only be applied in those situations where management has the ability to strongly influence or control the results. Sound principles of modern compensation practice require that compensation be linked to objectives within the control of management. The arbitrariness of BWG's proposal could seriously undermine LG&E Energy's entire incentive compensation program by adversely affecting its ability to attract, motivate and retain quality personnel or to instill appropriate performance incentives because employees would lack the ability to materially alter their incentive compensation award through their daily performance.

Q. Would the BWG recommendation for the short-term incentive plan actually create a direct link to the ESM?

A. No. First, tying short-term incentive compensation directly to the annual ESM results is simply unrealistic due to timing constraints. Review of the annual ESM fillings may take nine months to complete and, even then, the results are subject to change by Commission decision and ultimately the appellate courts. As a result, executive short-term compensation could be unreasonably delayed by the regulatory process if based upon the final ESM results approved by the Commission. Second, this recommendation is inconsistent with another recommendation made by BWG. Here, BWG recommends a change to LG&E Energy's short-term incentive compensation whereas in another section of the Report, BWG recommends adoption of a three-year cumulative ESM. Thus, their proposed changes to short-term compensation are not synchronized with their proposed change for a longer-term period of consideration for the ESM. Finally, the goal of regulation is to provide the utility with an opportunity, not a guarantee, to earn its allowed rate of return. BWG's proposal would effectively convert the executives responsible for LG&E and KU into guarantors that the allowed rate of return will be met.

Q. When confronted with the inconsistency in directly linking the short-term incentive program to a multi-year ESM, how did BWG respond?

A. In its Response to Data Request No. 15, BWG amended its recommendation in order to link the ESTICP to the annual ESM results so that the results period would match the incentive compensation period. BWG went on to say that the "long-term incentive compensation plan should likewise be consistent in rewarding behavior that results in the multi-year ESM results falling in or above the dead band." However, this new recommendation contradicts BWG's finding at page IV-6 of the Report that the "new goal for the 2003 E.ON Executive Long-Term Incentive Plan is a step in the right direction."

Q. In your opinion, are LG&E Energy's executive incentive compensation plan and the ESM sufficiently aligned at this time?

A. Yes. The current use of budgeted internal operating profit in the short-term incentive compensation plan is an adequate and reasonable link between the profitability of the utilities and the operation of the incentive plan. BWG criticizes the fact that, for senior executives, the short-term incentive opportunity is tied to the internal operating profit of LG&E Energy, which includes both regulated and non-regulated income. However, as noted by BWG at page I-4 of the Report, in 2002, the non-regulated businesses accounted for less than one percent of LG&E Energy's income. As a result, the use of the internal operating profit of LG&E Energy, rather than that of the utilities alone, is simply a distinction without a material difference. The BWG Report also ignores the fact that the proposed changes to the executive short-term incentive compensation are entirely unnecessary because the incentives created by the LG&E Energy compensation plans are wholly consistent with those envisioned by the Report: optimal financial performance over the short- and long-term. The interest of LG&E's and KU's shareholders dictate that management strives to maximize financial performance with or without an ESM. BWG found no evidence that the executives responsible for LG&E and KU have manipulated budgets or accounting in order to create unwarranted payouts. Just as management had the incentive to maximize LG&E's and KU's financial performance prior to the installation of the ESM, suggesting that the ESM must serve as the means of providing the incentive simply ignores the realities of business that already exist.

Q. What could happen if this recommendation is implemented?

A. BWG's recommendation to directly link the executive short-term incentive compensation program to the ESM would effectively convert the short-term incentive plan from a balanced, established component of variable pay for LG&E's and KU's management to something that is more comparable to deferred compensation than incentive compensation. However, this type of compensation would be unlike any other recognized by utilities or in an even larger market. BWG has itself admitted in its data responses to LG&E and KU that it is not aware of any utilities with executive compensation plans that are directly linked to an ESM or other form of alternative regulation. <u>See</u> Response to Data Request No. 9.

Q. Have you sought the advice of an outside expert concerning this BWG recommendation?

A. Yes. We have retained Richard Meischeid, Principal of Towers Perrin for his independent, professional opinion on this issue. He has twenty-five years of certain experience in providing independent advice on employee compensation matters. For the reasons set forth in his testimony, in his opinion, the BWG recommendation to directly link the results of the ESM to ESTICP is, in his words, "flawed."

Q. In its Report, BWG recommends at page III-11, Item 1, that LG&E and KU create an executive position whose sole function is to represent the Kentucky regulated companies. Do you agree with this proposal?

A. No. This recommendation is simply an unwarranted intrusion into the ability of LG&E's and KU's management to run the business. The proposal adds unnecessary costs, reduces management flexibility, and decreases operating efficiencies. BWG has itself expressly recognized at page III-9, Item 5, of the Report that "there is not apparent cross-subsidization between regulated and non-regulated affiliates." Because there does not appear to be any problem to address, it is not clear what additional benefit LG&E, KU or their customers can expect to derive from this executive realignment. BWG correctly points out in its Report at page I-3 that LG&E and KU "have implemented a streamlined organization focused on efficiency and cost control." BWG's recommendation would fly directly in the face of the stated objectives of the ESM program by creating an organization that is less streamlined, less capable of achieving efficiencies, and less likely to maintain control over costs. Without any supporting evidence of harm to LG&E, KU or their customers, BWG's recommendation dictates the implementation of a management structure that would result in higher costs to LG&E's and KU's customers.

Since at least 1994, LG&E Energy has held functional responsibilities for both the regulated and unregulated operations. In January 2000, LG&E Energy established LG&E Energy Services, Inc. as a means of complying with the requirements of the Public Utility Holding Company Act of 1935 ("PUHCA") because LG&E Energy became part of the PowerGen registered holding company system. Officers responsible for utility functions and non-utility functions became officers of LG&E Energy Services, Inc. in order to manage both LG&E and KU functions and comply with the requirements of PUHCA. Under this structure, officers continue to have regulated and non-regulated responsibilities.

In my professional opinion, the current management structure for LG&E and KU is efficient and effective. BWG's recommendation, if adopted, would reduce the current efficiencies and would diminish the present effectiveness in the present management structure. LG&E's and KU's shareholders and customers would be harmed by such impacts.

When confronted with this criticism, however, BWG amended its recommendation to state that they were simply "recommending a redistribution of executive responsibilities." Response to Data Request No. 37. With this amendment to BWG's recommendations, LG&E and KU commit to conduct annual internal audits of all service level agreements and to require each executive with supervisory authority over a regulated line of business to certify in writing each year, as applicable, that his or her line of business received the full measure of benefits to which it is entitled under these agreements, and that no unlawful cost shifting or cross-subsidization occurred during the prior year. Further, LG&E and KU will commit to designate a single executive responsible for ensuring that the audit and certification processes are completed as described above. This designation will not, however affect the current responsibilities of the executive. With these commitments, the Commission can be assured that the interests of the regulated entities are being adequately protected.

Q. Does this conclude your testimony?

A. Yes.

VERIFICATION

COMMONWEALTH OF KENTUCKY)
) SS:
COUNTY OF JEFFERSON)

The undersigned, **Paula H. Pottinger, Ph.D.**, being duly sworn, deposes and says she is the Vice President, Human Resources, for LG&E Energy Services, Inc., that she has personal knowledge of the matters set forth in the foregoing testimony, and the answers contained therein are true and correct to the best of her information, knowledge and belief.

____
PAULA H. POTTINGER, Ph.D.

Subscribed and sworn to before me, a Notary Public in and before said County and State, this _____ day of October 2003.

______________________________ (SEAL)
Notary Public

My Commission Expires:

____

Appendix A

PAULA H. POTTINGER, PH.D.

CURRENT POSITION: **LG&E Energy Services, Inc.**
Vice President, Human Resources

DATE APPOINTED: **June 1, 2002**

CAREER HISTORY	**DATES**
LG&E Energy Services, Inc., Div HR Director	1997-2002
LG&E Energy Corp., Mgr HR Development	1997-1997
Louisville Gas & Electric Co., Mgr Employee Development	1994-1997
Louisville Gas & Electric Co., Mgr Compensation	1993-1994
Louisville Gas & Electric Co., Mgr Organizational & Mgmt Dev	1989-1993

QUALIFICATIONS

BA – University of Notre Dame 1979
MA - Ohio State University, Industrial/Organizational Psychology 1983
Ph.D– Ohio State University, Industrial/Organizational Psychology, 1986

LANGUAGES

English

COURSES

E.ON International Management Development Seminar 2002
Electric Utility System Operations
Coaching for Performance
Kellogg Executive Development Program

EXTERNAL APPOINTMENTS / ACTIVITIES

The Louisville Zoo, Board of Directors – February 2003 to present
Maryhurst, Inc., Board of Directors – November 2002 to present
American Psychologists Association, Division 14; Member
Society of Psychologists in Management; Member
HR Planning Society; Member

Valerie L. Scott
Testimony

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INVESTIGATION PURSUANT TO KRS 278.260 OF THE EARNINGS SHARING MECHANISM TARIFF OF KENTUCKY UTILITIES COMPANY	))))	CASE NO. 2003-00334

AND

AN INVESTIGATION PURSUANT TO KRS 278.260 OF THE EARNINGS SHARING MECHANISM TARIFF OF LOUISVILLE GAS AND ELECTRIC COMPANY	))))	CASE NO. 2003-00335

TESTIMONY OF
VALERIE L. SCOTT
DIRECTOR, FINANCIAL PLANNING AND ACCOUNTING – UTILITY OPERATIONS
LG&E ENERGY CORP.

Filed: October 15, 2003

Q. Please state your name, position and business address.

A. My name is Valerie L. Scott. I am currently Director, Financial Planning and Accounting – Utility Operations, LG&E Energy Corp. My business address is 220 West Main Street, Louisville, Kentucky. I am testifying on behalf of Louisville Gas and Electric Company and Kentucky Utilities Company ("Companies") in this proceeding. A statement of my qualification is attached as Appendix A.

Q. What is the purpose of your testimony?

A: The purpose of my testimony is two-fold. First, my testimony supplements the testimony of Mr. Beer by explaining why, from a financial accounting perspective, the Commission should reject the auditor's recommendation that the Companies be required to implement a multi-year ESM based on the current ESM format. Second, I will address the auditors' concern regarding the Companies' failure to fully utilize certain "Service Level Agreements" and their related concern regarding the lack of "organizational separation" between the Companies and their unregulated affiliates.

Q: Please summarize the first recommendation.

A: The auditors claim that the existing annual ESM structure creates "[t]iming issues [that] represent a significant weakness because they may encourage the companies to shift costs between accounting periods in order to invoke an ESM factor revenue adjustment," thereby maximizing returns. (Report at V-7-8.) To prevent this potentiality, the auditors propose a multi-year ESM that would "consolidate" or combine the Companies' upper and lower earnings limits over such multi-year period for purposes of computing the ESM adjustment (customers' share of deficiency or surplus). A one-year revenue basis would then be used to compute the resulting ESM factor. At the end of the multi-year period, a true-up, or balancing adjustment, would be applied based on the actual ESM revenues for the collection period.

Q: Why should the Commission reject the auditors' multi-year ESM recommendation?

A: Implementing a multi-year ESM structure would be inappropriate for several reasons. In addition to the reasons set forth in Mr. Beer's testimony, the auditors fail to recognize that regulatory controls and processes are already in place that prevent the very behavior the auditors seek to discourage through a multi-year ESM -- "gaming" the ESM mechanism by shifting costs between accounting periods. Indeed, the fact that the auditors were unable to find *any evidence* that the Companies have even attempted to shift costs between accounting periods demonstrates how successful these controls and processes are in this regard.

Q: What are these regulatory controls and processes?

A: The Companies are audited annually by their external auditor and by the Internal Revenue Service, and are subject to periodic audits by this Commission, the Kentucky Revenue Cabinet, the Kentucky Transportation Cabinet, the Federal Energy Regulatory Commission, the Securities and Exchange Commission, and other third parties. These audits focus on various aspects of the Companies' operations, including state income taxes, state sales and use taxes, highway relocation work, and accounting, reporting and compliance matters.

Q: Apart from the fact that a multi-year ESM mechanism is not necessary to prevent the type of "gaming" envisioned by the auditors, are there flaws in the multi-year concept as proposed by the auditors?

A: Yes. The multi-year ESM mechanism proposed by the auditors reflects inconsistent treatment of revenue bases and earnings limits. Specifically, with regard to the three-year ESM example presented in the audit report (at page V-8), in the second and third years, the Companies' annual earnings limits are simply added together. This method is illogical, as each Company's earnings limit for any given year is dependent on that Company's capitalization for that year: capitalization is not additive. Moreover, even if multi-year earnings limits could be reasonably calculated, the use of multi-year earnings limits with a one-year revenue basis is inconsistent with long-standing ratemaking principles, as Mr. Beer points out in his testimony. All of the components used to calculate the ESM factor should be based on the same reporting period, consistent with Commission orders and Kentucky regulations establishing the Companies' base rates.

Q: Turning to the auditors' claims regarding the Companies' use of their Service Level Agreements, please describe briefly what these agreements are.

A: The Service Level Agreements referenced by the auditors are a product of the corporate restructuring consummated with the Powergen merger in 2000, at which time the Companies became subject to the Public Utility Holding Company Act ("PUHCA"). In order to comply with the requirements of PUHCA, LG&E Energy Services, Inc. was formed in 2000. The Service Level Agreements, which are not required by any regulatory body, were developed in 2001 by the Companies on their own initiative to govern the provision of services by LG&E Energy Services, Inc. to one or both Companies. The Agreements were specifically designed to facilitate the Companies' compliance with the requirements governing inter-affiliate transactions under PUHCA.

Q: The auditors allege that the Companies have not used their Service Level Agreements as intended because of a lack of organizational separation, and propose that the Companies be required to create this separation by naming "a single executive without conflicts of interest" to represent the Companies in affiliated transactions (Report at page III-8). Turning first to the auditors' claim that the Companies have failed to fully utilize their Service Level due to a lack of organization separation, do you agree?

A: No. Although I acknowledge that the Companies may not have fully utilized their Service Level Agreements as originally intended, it is important to recognize that the terms and principles of these Agreements – which, again, the Companies developed voluntarily – have been fully incorporated into the Companies' operations and oversight. Indeed, it is this very fact that led the Companies to afford less attention to these Agreements – not, as the auditors' claim, a lack of organization separation.

Q: Has the Companies' failure to utilize their Service Level Agreements as originally intended harmed the Companies' customers?

A; No. In fact, the auditors cannot point to a single instance of inappropriate cost shifting or cross-subsidization as a result of the Companies' use or non-use of their Service Level Agreements. To the contrary, the auditors' report finds that:

> [t]he basis for costing and pricing transactions between LG&E/KU and [their] affiliates is appropriate and supported, the affiliate transactions comply with the letter of Kentucky and SEC requirements, and *there is no apparent cross-subsidization between regulated and non-regulated affiliates.* (Report at III-10, emphasis added.)

Q: Given the auditors' finding that "there is no apparent cross-subsidization" between the Companies and their affiliates, do you agree with their proposal that the

Companies should restructure their executive structure by naming "a single executive without conflicts of interest" to represent the Companies in affiliated transactions (Report at page III-8)?

A: Absolutely not. Naming such an individual would serve only to waste ratepayer dollars, counter to the many actions taken by the Companies to reduce costs. The auditors' findings demonstrate that there is simply no wrong that needs to be remedied through the creation of a new executive position responsible solely for the Companies, nor have the auditors pointed to any additional benefits the Companies or their customers could expect to derive from the proposed executive realignment.

The auditors correctly recognize at the outset of their report that the Companies have "implemented a streamlined organization focused on efficiency and cost-control . . . ." Report at I-3. In the absence of *any* harm or detriment to the Companies or their customers as a result of the existing executive structure, a corporate realignment as proposed by the auditors would serve only to create an organization that is less streamlined, less capable of achieving efficiencies, and less likely to maintain control over costs, directly contrary to the ESM's stated objectives.

Moreover, the auditors fail to recognize that current systems are already in place that provide the very ratepayer protection envisioned by their corporate realignment proposal. Specifically, the reporting requirements of the Kentucky Public Service Commission, the Virginia State Corporation Commission, and the Securities and Exchange Commission ensure that cost allocations between the Companies and their affiliates are made appropriately and in a manner consistent with the law.

Q: In justifying their executive realignment proposal, the auditors claim that "Internal Audit has had significant reductions in resource commitments between 2000 and 2002" (Report at I-18). Is this an accurate statement?

A: No. In fact, the Companies' internal audit group has, since 2000, restructured and evolved its protocols in a manner consistent with benchmark data from the Edison Electric Institute, the American Management Association, the Institute of Internal Auditors, and an outsourcing proposal from Arthur Andersen. Of concern to the Companies is the fact that apparently the auditors made no inquiry into the extent to which internal auditing resources have been allocated to the Companies since 2000. Had such a line of inquiry been pursued, the auditors would have found that the allocation of audit resources to the utilities has actually *increased,* as a percentage of the whole, each year. The suggestion that the Companies are not subject to rigorous review and audit is, therefore, simply not based on fact.

Q: Despite the lack of any evidence of harm to the Companies or their customers, are the Companies willing to accommodate the auditors' concerns in any respect?

A: Yes. To accommodate the auditors' concerns, the Companies will commit to elevating the importance of their Service Level Agreements in the management of their operations, and to verify the effectiveness of these agreements through increased internal audit oversight. Specifically, the Companies will agree (i) to conduct annual internal audits of all Service Level Agreements; and (ii) to require each executive with supervisory authority over a regulated line of business to certify in writing each year, as applicable, that his/her line of business received the full measure of benefits to which it is entitled under these Agreements, and that no unlawful cost shifting or cross-subsidization occurred during the prior year. Further, the Companies will commit to designate a single executive responsible for ensuring that the audit and certification processes are completed as described herein. With these commitments, regulators can be assured that the interests of the regulated entities are being adequately protected.

Q: Does this complete your testimony?

A: Yes.

VERIFICATION

COMMONWEALTH OF KENTUCKY)
)
COUNTY OF JEFFERSON)

The undersigned, **Valerie L. Scott**, being duly sworn, deposes and states that she is Director, Financial Planning and Accounting Utility Operations for LG&E Energy Services Inc., that she has personal knowledge of the matters set forth in the foregoing testimony and exhibits, and the answers contained therein are true and correct to the best of her information, knowledge and belief.

Valerie L. Scott

VALERIE L. SCOTT

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 15th day of October, 2003.

Tammy J. Elzy (SEAL)

Notary Public

My Commission Expires:

TAMMY J. ELZY
NOTARY PUBLIC
STATE AT LARGE
KENTUCKY
My Commission Expires Nov. 9, 2006

APPENDIX A

Valerie L. Scott

Director, Financial Planning & Accounting – Utility Operations
LG&E Energy Corp.
220 West Main Street
Louisville, Kentucky 40202
(502) 627-3660

Previous Positions

February 1999 – August 2002 – Director, Trading Controls & Energy Marketing Accounting

May 1998 – February 1999 – Manager, Trading Controls and Manager, Financial Planning, Reporting and Special Projects

July 1993 – May 1998 – Manager, Corporate Internal Auditing

October 1991 – March 1993 – Senior Staff Accountant

Richard F. Meischeid
Testimony

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INVESTIGATION PURSUANT TO KRS 278.260 OF THE EARNINGS SHARING MECHANISM TARIFF OF KENTUCKY UTILITIES COMPANY	))))	CASE NO. 2003-00334

AND

AN INVESTIGATION PURSUANT TO KRS 278.260 OF THE EARNINGS SHARING MECHANISM TARIFF OF LOUISVILLE GAS AND ELECTRIC COMPANY	))))	CASE NO. 2003-00335

TESTIMONY OF
RICHARD F. MEISCHEID
PRINCIPAL, TOWERS PERRIN

Filed: October 15, 2003

Q. Please state your name, position and business address.

A. My name is Richard F. Meischeid. I am Principal of Towers Perrin. My business address is Centre Square East, 1500 Market Street, Philadelphia, Pennsylvania 19102. Towers Perrin has provided executive compensation consulting to LG&E Energy Corp. since May of 1990. I have twenty-five years experience in designing compensation systems linked to initiatives for improving productivity and enhancing shareholder value creation. I have standing professional relationships with numerous clients (many of which are in the utility and energy industries) where I serve as the compensation consultant to the board of directors. I have previously provided testimony for other clients in various jurisdictions on the topic of compensation levels and annual incentive practices. A complete statement of my qualifications attached in Appendix A.

Q. Please provide a brief overview of Towers Perrin.

A. Towers Perrin is one of the world's largest management and human resources consulting firms, helping organizations manage their investment in people to achieve measurable performance improvements. The firm has over 9,000 employees and 79 offices in 75 cities worldwide. Towers Perrin's compensation practice is one of the largest in the world with over 500 consultants. In order to have practitioners who understand and are familiar with the unique characteristics of a particular industry, many of our consultants focus on a particular industry. With respect to electric utilities, industry specialization is particularly important given the implications of the regulatory environment; therefore, Towers Perrin has dedicated energy and utility industry practitioners specializing in compensation, benefits, and retirement services

Q. Please summarize what Towers Perrin was retained to do.

A. We were engaged by Louisville Gas and Electric Company ("LG&E") and Kentucky Utilities Company ("KU") (collectively the "Companies") to provide an opinion on the reasonableness of the recommendation in the Barrington-Wellesley Group's report, specifically that the Earnings Sharing Mechanism ("ESM") be directly linked to LG&E Energy Corp.'s executive short-term incentive program.

Q Have you reviewed the report issued by the Barrington-Wellesley Group?

A. Yes, I have reviewed Sections IV-4 through IV-6, which address Barrington-Wellesley Group's ("BWG") findings regarding the annual incentive plan and its recommendations for changes. I have also reviewed the portion of Section V-6 pertaining to Timing Issues.

Q. What specific tasks did you perform?

A. We performed the following work: 1) reviewed the relevant sections of the report, 2) compared LG&E Energy Corp.'s current annual incentive plan with competitive practice in the utility industry, and 3) reviewed data regarding goals and the goal-setting process for short-term incentive plans.

Q. On what sources of compensation data did you rely?

A. We used data from Towers Perrin's 2001 Annual Incentive Plan Design Survey (including a custom sample of utility companies), an analysis of publicly-filed proxy statements from a select group of utility companies, and Towers Perrin's knowledge of the industry.

Q Please describe the typical process of a short-term incentive plan.

A. First, managers and employees work together to set goals. Goals are typically a combination of: (1) overall company (e.g., earnings, customer satisfaction); (2) business unit or departmental (e.g., O&M, reliability); and (3) individual goals related to the individual's specific role. Next, performance is periodically assessed during the performance period and ongoing feedback is provided regarding the progress toward achieving the goals. Third, at the end of the performance period, results are compared to the goals and a final assessment made on the degree of achievement. Finally, payouts are made shortly after the conclusion of the performance period. The metric used in LG&E Energy Corp.'s annual incentive plan (internal operating profit) can be set at the start of the performance period, reviewed throughout the period, and measured at the end.

Q. Is it typical to be able to adjust the results after the close of the performance period?

A. The purpose of an incentive program is to provide the participants with a clear 'line of sight' between what they and the company need to accomplish and the reward if the goals are achieved. Since goals can't be set with perfect knowledge of actual events, it is necessary to provide for judgment in cases where actual circumstances distort the 'line of sight.' To the extent possible, adjustments are specified at the start of the performance period e.g., weather adjustment for earnings, the impact of write-offs resulting from legacy issues or accounting changes. Regardless of the nature of the adjustment, the decision is made in a timely manner and the explanation provided in conjunction with the payment of any incentive awards.

Q. How does this process compare with the BWG recommendation regarding ESM?

A. Under BWG's proposal, a meaningful portion of the short-term incentive would be linked to the ESM. During the performance period, progress could be reviewed on actual results compared to the ESM goal. At the end of the year, the Companies would file their results, but no awards could be made until the Commission reviewed the Companies' filings and issued final rulings on the ESM filings for the operating period. The proposed process, therefore, would deviate from standard practice in two important respects – 'line of sight' and timing.

Q. Are the BWG recommendations on IV-6 regarding the linkage of the executive short-term incentive plan with the ESM reasonable and consistent with competitive practice?

A. No, due to the reasons stated above these recommendations are not consistent with competitive practice. First, for an annual incentive plan to be effective, the participant must have a clear understanding of the goal and what they as a participant can do to achieve it. Although ESM is an objective standard, it fails on this criterion because the year-end adjustment process is equivalent to starting the measurement process over. From a regulatory perspective this review process is a necessity but from a compensation perspective it renders the incentive process meaningless. Second, to reinforce the connection between the performance and reward, the payout must be made on a timely basis after the conclusion of the performance period. The review required under the ESM structure could result in significant delays. For example, the ESM 2002 filing remains unresolved as of October 15, 2003.

Q. Do other utility companies typically include rates as a component of their annual incentive plans?

A. No. None of the 25 utility companies responding to Towers Perrin's 2001 <u>Annual Incentive Plan Design Survey</u> provided rates as a primary performance metric. Commonly used metrics were financial, e.g. earnings per share and/or net income, and expectations for these performance measures were most frequently determined by performance versus budget. Only four percent of companies in the survey reported using a timeless or absolute standard for determining performance. Furthermore, a review of selected 2003 utility industry proxy statements also found that rates are rarely used as a performance metric, although financial measures, business unit and individual performance, and other non-financial metrics such as customer satisfaction, safety, diversity and reliability were prevalent. This analysis found only one company – WPS Resources – using rate levels as one of the metrics in its annual incentive program. WPS Resources' proxy statement indicates that rate levels – specifically a comparison of rates relative to competitors – is one of eight metrics included in the program.

Q. Is LG&E Energy Corp.'s current annual incentive plan aligned with competitive practice?

A. Yes. The plan is consistent with competitive practice for the following reasons: the metrics used are typical of practices in the utility industry, and the participants are involved in the goal-setting process. The payout is determined and made within two months of the conclusion of the performance period. In addition, LG&E Energy Corp.'s use of a financial metric - internal operating profit – is consistent with practices by other companies in the utility industry.

Q. In your opinion, is the current LG&E Energy Corp. annual incentive plan reasonable?

A. Yes, the plan is reasonable as currently structured.

Q. Do you agree with BWG's suggestion that the annual incentive plan should use an absolute measure for financial performance?

A. No. If by an absolute measure such as ESM the auditors are suggesting a measure that once established is independent of any particular performance period (e.g. fixed for an indefinite period of time), we would not recommend that LG&E or KU Energy Corp. adopt this approach with respect to its short-term incentive plan. The majority of general industry and regulated companies calibrate their incentives to budget because doing so allows for the determination of an appropriate risk/reward relationship, e.g. the target level is generally set in relation to the budget level with a defined range above (the maximum payout) and below (the threshold payout) the target that is consistent with the range of potential opportunities in the given performance period. Furthermore, as indicated in our 2001 Annual Incentive Plan Design Report, the majority of companies determine expectations for performance measures based on performance against budget.

Q. If the Commission were to adopt the recommendations, would LG&E and KU be harmed?

A. Yes. Implementing ESM under the current structure would severely undermine the effectiveness of LG&E Energy Corp.'s incentive plan. While the impact is hard to quantify, it is reasonable to expect that the Companies would experience a decrease in the effectives of the short-term incentive plan and difficulty in attracting and retaining employees.

Q. What is your professional opinion on BWG's recommendation to link ESM and short-term compensation?

A. BWG's recommendation is flawed for the reasons I have stated and should be rejected. I have strong concerns about linking a regulatory tool to the compensation system. The requirement for a deliberate, inclusive review process inherent in the ESM structure renders it a flawed device for compensation purposes. Maintaining LG&E Energy Corp.'s current approach to its incentive program will retain the benefits elaborated in the Audit Report without intruding on management's ability to obtain the highest value from its human resources.

Q. Are you aware that the BWG report has since been amended and that the same recommendation applies to the long-term incentive plan?

A. Yes. I have reviewed Question No. 15 as submitted by LG&E and KU and the corresponding response prepared by BWG. Based on that response, it does not appear that our concerns surrounding ESM (namely, the adjustment process and the timing of the payout following the end of the performance period) have been addressed. Therefore, our concerns about including it in the long-term incentive plan would be the same.

Q. Does this conclude your testimony?

A. Yes.

VERIFICATION

STATE OF PENNSYLVANIA)) SS: COUNTY OF PHILADELPHIA)

The undersigned, **Richard F. Meischeid**, being duly sworn, deposes and says he is Principal of Towers Perrin., that he has personal knowledge of the matters set forth in the foregoing testimony, and the answers contained therein are true and correct to the best of his information, knowledge and belief.

____
RICHARD F. MEISCHEID

Subscribed and sworn to before me, a Notary Public in and before said County and State, this _____ day of October 2003.

(SEAL) ________________________________
Notary Public

My Commission Expires:

____

Appendix A

I am a Principal in Towers Perrin's Philadelphia Consulting Office where I am responsible for managing the Executive Compensation practice. I also lead Towers Perrin's energy services' compensation practice. I consult with both energy and general industry companies in the areas of executive compensation, total reward strategy, and value-based management. I joined Towers Perrin in 1978 and was elected a Principal of the firm in 1983.

I have twenty-five years experience in designing compensation systems linked to initiatives for improving productivity and enhancing shareholder value creation. I have standing professional relationships with numerous clients where I serve as the compensation consultant to the board. Towers Perrin has provided executive compensation consulting to LG&E Energy Corp. since May of 1990.

Other organizations for which I have conducted assignments include American Electric Power, Bethlehem Steel, Cigna Corporation, Comcast Corporation, Consolidated Edison, Constellation Energy, DuPont, Exelon, General Electric, Hershey Foods Corporation, Pacificorp, Reliant Energy, Saint Gobain, Sithe Energy, Scottish Power, Sunoco, The Southern Company, TI Group plc, and UGI Corporation.

I have previously provided testimony regarding total compensation levels and annual incentive practices in the utility industry for the following companies in these jurisdictions:

- Delmarva, Delaware
- Exelon, Illinois
- Minnegas, Minnesota
- Montana Power, Montana
- NSP, Wisconsin
- PacificCorp, Utah
- PSE&G, New Jersey
- UGI, Pennsylvania

Before joining Towers Perrin, I was associated with The Wharton School at the University of Pennsylvania, where I served as a graduate teaching assistant and was a founding member of The Wharton School's Entrepreneurial Center. I graduated from St. Francis College in 1970 and earned an M.B.A. from The Wharton School in 1978.

I am a member of World at Work (formerly the American Compensation Association) and have spoken at that organization's annual conference. I have also delivered presentations before the Edison Electric Institute, the American Gas Association, and the Conference Board. In addition I have published an article regarding the role and design of incentives in the utility industry in Electric Perspectives, a magazine published by the Edison Electric Institute.

Michael S. Beer
Testimony

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INVESTIGATION PURSUANT TO KRS 278.260 OF THE EARNINGS SHARING MECHANISM TARIFF OF KENTUCKY UTILITIES COMPANY	))))	CASE NO. 2003-00334

AND

AN INVESTIGATION PURSUANT TO KRS 278.260 OF THE EARNINGS SHARING MECHANISM TARIFF OF LOUISVILLE GAS AND ELECTRIC COMPANY	))))	CASE NO. 2003-00335

TESTIMONY OF
MICHAEL S. BEER
VICE PRESIDENT, RATES AND REGULATORY
LG&E ENERGY CORP.

Filed: October 15, 2003

Q. Please state your name, position and business address.

A. My name is Michael S. Beer. I am the Vice President of Rates and Regulatory for LG&E Energy Corp, Louisville Gas and Electric Company ("LG&E") and Kentucky Utilities Company ("KU") (collectively the "Companies"). My business address is 220 West Main Street, Louisville, Kentucky. A statement of my qualification is attached as Appendix A.

Q. Have you previously testified before this Commission?

A. Yes. I testified on regulatory policies in Case No. 2001-104, *In the Matter of: Joint Application for Transfer of Louisville Gas and Electric Company and Kentucky Utilities Company in Accordance With E.ON AG's Planned Acquisition of Powergen plc*, and in environmental surcharge proceedings and Certificate of Convenience and Necessity cases involving LG&E and KU.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to present the position of LG&E and KU on whether the Earnings Sharing Mechanism ("ESM") should be continued now that the Companies have the benefit of recommendations of the Barrington-Wellesley Group, Inc. ("BWG")'s *Focused Management Audit of Louisville Gas and Electric Company's and Kentucky Utilities Company's Earnings Sharing Mechanism Report* (the "Report"). My testimony will also provide the response of LG&E and KU to the findings and recommendations in the BWG Report.

THE ESM SHOULD BE CONTINUED

Q. Why did LG&E and KU file their tariffs to continue the ESM?

A. The Companies filed tariffs to continue the ESM in order to comply with the commitments required by the Commission in approving the PowerGen and E.ON acquisitions. In its Order of May 15, 2000, *In the Matter of: Joint Application of Powergen plc, LG&E Energy Corp., Louisville Gas and Electric Company, and Kentucky Utilities Company for Approval of a Merger*, Case No. 2000-095, the Commission conditioned its approval of the transfer of control over and acquisition of LG&E and KU upon the following commitment:

> Upon the expiration of the LG&E and KU ESM provided for in the Commission's January 7, 2000 Orders, the Applicants commit to propose extension of the ESM or some other method of regulation that will continue to provide LG&E and KU with incentives to make improvements while providing a mechanism to share with customers the benefits realized from those improvements.

Order at page 10 to Appendix A, ¶17.

Again, in its Order of August 6, 2001, *In the Matter of: Joint Application for Transfer of Louisville Gas and Electric Company and Kentucky Utilities Company in Accordance with E.ON AG's Planned Acquisition of Powergen plc*, Case No. 2001-104, the Commission approved the acquisition and the right to control LG&E and KU upon the following commitment:

> Upon the expiration of the LG&E and KU ESM provided for in the Commission's January 7, 2000 Orders, the Applicants commit to propose extension of the ESM or some other method of regulation that will continue to provide LG&E and KU with incentives to make improvements while providing a mechanism to share with customers the benefits realized from those improvements.

Order at page 12 of Appendix A, ¶51. LG&E and KU have complied with these commitments by filing the ESM tariffs, and have participated in the focused management audit conducted by BWG earlier this year.

Q. Should the Commission determine a new return on equity in this proceeding for purposes of calculating the ESM?

A. No. The return on equity used to calculate the ESM should be the same return on equity used to establish the revenue requirement, and thus the base rates, for LG&E and KU. It is essential that the return on equity used in the calculation of the base rates match the midpoint of the dead band range of the ESM, as the base rates produce the revenue used to determine credits or charges to customers under the ESM. Thus, the return on equity should be decided only in a base rate case where LG&E's or KU's complete cost of providing electric service can be reviewed and evaluated.

Q. Are the Companies, the Commission or any persons interested in LG&E's and KU's base rates precluded from taking action with respect thereto during the course of this proceeding or at any time thereafter?

A. No. LG&E and KU have a fundamental statutory right to seek a base rate increase regardless of whether they are operating under an ESM. Nor does the presence of an ESM prohibit the Commission from conducting an investigation into the reasonableness of the Companies' base rates or otherwise prohibit any interested person from filing a complaint at the Commission concerning the reasonableness of such rates. Although the results of the ESM for a particular operating period may well present strong evidence of the need to take such actions, these fundamental rights will remain unaffected by a decision in this or any ESM proceeding. The statutory grants of authority to the

Commission from the General Assembly do not provide the Commission the power to alter or amend these rights.

Q. Should the Commission extend the ESM for an additional three year period under its existing terms and conditions?

A. Yes. LG&E and KU request that the Commission extend the ESM for an additional three-year period under its existing terms, renewing both the current symmetrical range or "dead band" of 100 basis points above or below the threshold, and the existing symmetry of 60 percent shareholder/40 percent customer sharing outside the deadband. The existing ESM structure properly apportions the risk of under-earning and over-earning between shareholders and ratepayers, and provides sufficient incentive for LG&E and KU to continue operating under the ESM. Should the Commission modify the current terms of the ESM, LG&E and KU would expect to be afforded a reasonable opportunity to evaluate any such modifications. As the Commission correctly recognized in its January 7, 2000 orders in Case Nos. 98-474 and 98-426, that LG&E's and KU's "full support and commitment is essential to make [the ESM work]" and that "ESM incentives will only work if they are fully supported by" LG&E and KU.

Findings of BWG 's Report Concerning the ESM Structure

Q. Do you agree with BWG's finding number 1 at page V-4 of the Report concerning LG&E's and KU's compliance with the ESM filing requirements?

A. Yes. BWG's Report at page V-4 found that LG&E and KU had complied with the ESM filing requirements and that the ESM filings had been filed on time and were complete and reasonably accurate. BWG noted there were, in a few cases, errors that were corrected in a timely manner. We agree strongly with the observation by BWG that "communication between the Companies and the Commission is particularly important" and are committed to maintaining and improving that communication as requested by the Commission.

Q. Do you agree with finding number 2 at page V-4 of BWG's Report?

A. Yes, with the clarification that the ESM does not deprive the Companies of their fundamental right to file a base rate case, if necessary, at any time during the effectiveness of the ESM.

The ESM does serve to encourage longer periods between rate cases by allowing the utility to collect 40 percent of the shortfall necessary to achieve the lower end of the dead band range. While this is not an adequate substitute for base rate case relief for any extended period of time, the ESM's "shock absorber" impact does mitigate some of the impact of insufficient under-earnings for a short period of time.

Q. Do you agree with finding number 3 at page V-5 of BWG's Report?

A. Yes, except for the comment that the ESM provides "somewhat less" incentive to increase efficiency than traditional regulation. This particular finding has no application to companies like LG&E and KU. For years, both Companies have operated to a world-class standard of excellence, providing their customers outstanding value in retail electric service through a combination of low rates and exceptional service. As Mr. Rives points out in his testimony, the Companies' service ranked among the best among utilities nationwide again this year, as measured by J.D. Power & Associates, an international marketing information firm. LG&E and KU will continue in the future, as they have in the past, to operate through innovation and achieve efficiencies with high quality customer service. Thus, while the ESM has not created a new corporate mindset for

LG&E and KU, it has served to re-enforce existing corporate initiatives to achieve efficiency and customer service.

Q. Do you agree with finding number 4 at pages V-5 through V-5 of BWG's Report?

A. No. BWG's Report asserts that "[o]ne weakness of the ESM that is also commonly found in traditional regulation is the use of a Fuel Adjustment Clause gives no direct incentive to minimize fuel costs or maximize generating efficiency." LG&E and KU disagree. The ESM is not intended to provide incentives to minimize fuel costs. The fuel clause revenues and expenses are removed in the ESM calculation. Moreover, BWG's finding is incorrect because the ESM does encourage maximum generating efficiency through the inclusion of off-system sales margins in the calculation of the ESM.

BWG's suggestion that the "use of a Fuel Adjustment Clause gives no direct incentive to minimize fuel costs or maximize generating efficiency" is at odds with the Commission's determination in its Orders in Case No. 98-426 and 98-474 that LG&E and KU have "significant incentives" for LG&E and KU "to keep fuel costs at a minimum level already exist, including a review of [their] fuel costs through the administrative process established under 807 KAR 5:056, increased margins realized from inter-system sales, and the increased opportunity to consummate profitable inter-system sales."

BWG's second finding in this portion of the Report concerns whether the ESM adequately addresses large investments in capital projects such as base load generating plants. The Auditors recognize that one or more rate cases may have to be filed during a period of intense capital construction while an ESM is in place. This is consistent with LG&E's and KU's position that the Companies have the right to file a base rate case while an ESM in effect. As stated earlier in my testimony, the Commission lacks the authority to restrict LG&E's and KU's right to file base rate cases at any time during operation of an ESM. However, the Companies do not necessarily agree with the observation that an ESM could possibly be suspended for a period of time as a result of the construction program.

BWG's finding that the ESM has a "weakness" because it "provides no direct control over financing costs of the capital structure" is misplaced because it overlooks the Commission's authority to approve the issuance of any security or evidence of indebtedness under KRS 278.300. LG&E and KU dispute that the ESM provides an incentive to increase capitalization and increase the equity ratio in order to increase the deadband dollar limits as contended by BWG. BWG found no evidence that LG&E or KU were attempting to take advantage of this purported weakness. This is an example of BWG's Report attempting to find a problem that does not exist.

As explained below in my testimony and in the testimony of Ms. Scott, LG&E and KU also do not agree with BWG's finding that the ESM has a "significant weakness" in its "structure" that can be "gamed or manipulated" by shifting costs into future operating periods. BWG "found no indication that suggests the Companies have shifted costs into 2002 for ESM recovery purposes." This is another example of BWG's Report identifying a problem that simply does not exist.

BWG's Report suggests that the ESM has a weakness because annual ESM filings are based on actual revenues and expenses of each year with only limited specific adjustments approved by prior Commission orders. LG&E and KU disagree. The Commission's previous decision to allow only limited ratemaking adjustments based on prior orders was sound because it prevents the ESM annual filing from becoming cumbersome and keeps the annual reviews from resulting in general rate proceedings. Under the present practice and procedure, the Companies can petition for the deferral of costs incurred as a result of any extraordinary events in a separate proceeding and, upon approval by the Commission through an order, can include an adjustment in the annual ESM filings to defer and amortize those costs to properly match revenues and expenses.

THE THREE BWG RECOMMENDATIONS ADDRESSED IN THIS TESTIMONY

Q. Please identify the three recommendations of BWG that you will be addressing herein.

A. BWG first recommends that the Commission should implement a multi-year ESM based upon LG&E's and KU's current ESM format. Second, BWG recommends that LG&E and KU work with the Commission Staff to identify a means for adequately addressing concerns regarding the timely communication of issues related to the current year's ESM filings. Finally, BWG recommends that the ESM should not preclude LG&E and KU from petitioning for, nor preclude the Commission from allowing, the deferral of costs incurred as a result of extraordinary events.

Q. Do you agree with the recommendations in BWG Report concerning a three-year consolidated ESM?

A. No. At pages V-7 to V-8 the Report states: "The Commission should implement a multi-year ESM based on the current ESM format. Timing issues represent a significant weakness because they may encourage the companies to shift costs between accounting periods in order to invoke an ESM factor revenue adjustment." This recommendation should be rejected for at least five reasons: (1) the proposal addresses problems that do not exist; (2) the proposal reduces incentives; (3) the proposal destroys the current alignment between the annual ESM filing and the Companies' other annual reporting requirements; (4) the proposal exacerbates the inequities resulting from the lag between cost incurrence and payment; and (5) the proposal treats the revenue basis and earnings limits inconsistently.

The Proposal Addresses Problems That Do Not Exist.

First, this recommendation, like some other recommendations in the BWG Report, is offered to address problems that the Report found did not exist. BWG acknowledges that "[r]egulated utilities commonly move transactions that create costs between accounting periods for normal business reasons" and that such actions "are generally within the bounds of normal business practices." (V-6). BWG found no evidence that the Companies improperly shifted costs between accounting periods or otherwise attempted to "manipulate" or "game" the ESM. (V-7). Indeed, the BWG Report characterized the Companies as being "well-managed utilities with a strong management team in place" (I-2) and as having "reputations for being reliable, customer service oriented utilities" (VIII-2). Thus, there is no reasonable basis for a "preventative" adjustment to the ESM, especially when such an adjustment has adverse consequences for the Companies.

Moreover, for this cost-shifting conspiracy to work satisfactorily it also has to be undetected by the governmental agencies and annual audits by the external auditors. However, especially under the hypothetical circumstances presented in the BWG Report, there undoubtedly would be very acute scrutiny of LG&E's and KU's financial reports under such circumstances. The present adverse consequences of being "caught" trying to "game" the ESM system are so severe compared with what little could be gained from such practices (i.e., only 40 percent of a relatively small shortfall below the lower deadband) from a "managed" ESM, that it would be irrational to engage in such conduct.

The Proposal Reduces Incentives.

Second, BWG's recommendation for a single three-year consolidated ESM is unreasonable because the multi-year ESM severely dilutes the incentive under the current ESM and therefore is contrary to the objective of the ESM expressed by the Commission in its orders. The potential impact of the recommendation can be shown through an analysis of the three previous years when the ESM was in place. The Report presents such a comparison at pages V-8 and V-9. The table below summarizes the results of the current year-by-year ESM for 2000, 2001 and 2002, and the pro forma results for a three-year cumulative ESM for that same three-year period:

Comparison of Amounts Recovered from Ratepayers ($ Million)		
	Year-by-Year ESM	3-Year Cumulative ESM
LG&E	13.2	2.1
KU	10.6	0.0

This table shows that the three-year cumulative ESM would produce almost no recovery of shortfalls from ratepayers compared to the year-by-year ESM. The reason for this negligible result for the cumulative ESM is the cumulative impact on the size of the deadband. This is shown below:

Comparison of Size of Deadband ($ Million)		
	Average for Year-by-Year ESM	3-Year Cumulative ESM
LG&E	14	40
KU	12	37

The above table indicates that the effective deadband for the cumulative ESM is much wider than for the year-by-year ESM. Due to the combining of the (offsetting) effects of positive years and negative years to get the three-year cumulative earned return, the cumulative effect of the deadband makes it more likely that LG&E and KU would fall within the deadband. In short, with a three-year cumulation of the deadband, the Companies are much more likely to be within the deadband than on a year-by-year basis. The impact of this recommendation cannot be overstated: if the Companies are far more likely to be within the deadband for a three-year cumulative ESM, why would LG&E and KU be willing endure such a process when the net effect is likely to be negligible and delayed for three years? This effect dilutes the benefits of the ESM both for ratepayers when earnings exceed the top of the deadband and for shareholders when earnings fall below the bottom of the deadband.

The Proposal Loses The Benefit of Alignment Between Annual Filing And Other Annual Reporting Requirements.

Third, the alignment of an annual filing with other annual financial reporting mechanisms is lost.

The Proposal Exacerbates The Inequities Resulting From The Lag Between Cost Incurrence And Payment.

Fourth, the multi-year ESM exacerbates the inter-generational inequities resulting from the lag between cost incurrence and cost allocation and payment. The matching principle of ratemaking -- aligning cost responsibility with cost incurrence -- is violated by this proposal. BWG dismisses this criticism by contending that ratemaking does not "always strictly" follow this principle, but concedes that "LG&E and KU may require the use of estimates when booking expected ESM-related over- and under- recoveries depending on the actual mechanics of a multi-year ESM." (BWG Data Response No. 17). BWG fails to mention the havoc that such a recommendation would have on LG&E's and KU's books for the three-year period.

The Proposal Treats The Revenue Basis And Earnings Limits Inconsistently.

Fifth, the multi-year ESM example provided in the Report inconsistently treats the revenue basis and earnings limits. For the second and third years, the annual earnings limits are simply added together. This is not reasonable in that the earnings limit for each year is dependent upon the capitalization for that year, which is not additive. Furthermore, even if multi-year earnings limits could be reasonably calculated, the use of multi-year earnings limits with a one-year revenue basis is illogical and inconsistent with long-standing ratemaking principles. All of the components used to calculate the ESM factor should be based on the same reporting period, consistent with Commission orders and Kentucky regulations establishing the Companies' base rates.

Q. Do you agree with the recommendations in BWG Report concerning a more detailed explanation of major accounting changes or other elements of the filing?

A. The Companies believe that the current reports used in the annual ESM filings provide an adequate amount of detailed information because the ESM tariff is a formulaic rate. The filings must continue to be straightforward and without controversy or undue administrative burden. In the first three ESM annual reviews, the Commission has scheduled an informal conference for the purpose of allowing the representatives of the Companies to offer an even more detailed explanation and to answer questions from the customer representatives and Commission Staff. However, the Companies are always willing to provide the Commission with any additional information which may be reasonably required to evaluate these filings or understand the Companies' electric operations.

The Companies do not support the consideration of more frequent ESM filings. LG&E and KU presently file quarterly jurisdictional balance sheets and income statements with the Commission. LG&E's quarterly filing separate its gas and electric operations. KU's electric operations are presented on a Kentucky jurisdictional basis. This information should mitigate rather than exacerbate the need for additional filings.

Q. Do you agree with the recommendation in BWG Report that the ESM should not preclude the Companies from petitioning for, nor preclude the Commission from allowing, the deferral of costs incurred as a result of extraordinary events?

A. The recommendation should be clarified to state that the ESM should not (1) deprive the Companies of their right to petition this Commission at any time for the recovery of reasonably-incurred costs in a general rate case, or (2) discourage this Commission from approving the timely deferral of costs incurred as a result of extraordinary events in a proceeding separate from the ESM annual reviews. LG&E and KU do not agree that the issue of deferring costs as a result of an extraordinary event should be an issue for decision in an annual review of an ESM operating period, but could be considered and decided in a separate proceeding.

THE BWG RECOMMENDATION TO LINK INCENTIVE COMPENSATION WITH ESM RESULTS

Q. Do you agree with the recommendation in BWG Report that Executive Short-Term Incentive Compensation Plan should be directly linked to the ESM?

A. No. The recommendation is yet another example of a recommendation offered to address a problem that the Report found did not exist. BWG's Report contains no evidence that LG&E and KU in connection with their administration of the Executive Short-Term Incentive Compensation Plan ("ESTICP") (1) have deliberately set performance goals so unreasonably low as to be readily attainable and to assure a payout even if the financial results of the Companies were not met or (2) have manipulated the use of the current measure of financial performance (Internal Operating Profit) to effectively assure a payout regardless of the operating returns of LG&E or KU. Notwithstanding this lack of evidence, BWG's Report proceeds to recommend that the ESTICP be "directly linked" to the ESM. Indeed, in discovery, BWG has conceded that it has no:

1. evidence of any utilities with executive compensation plans that are directly linked to an ESM or other forms of alternative ratemaking/regulation;
2. empirical evidence that demonstrates linking a utility's executive compensation plan directly to an ESM will provide benefits to utility customers; and
3. empirical evidence that demonstrates that linking a utility's executive compensation plan directly to an ESM is more advantageous than indirectly linking compensation to a utility holding company's internal operating profit.

(BWG's Data Responses to Nos. 9, 10 and 11). This recommendation should be rejected for several other reasons. In addition to the reasons presented in the testimony of Paula H. Pottinger, Ph.D., Vice President, Human Resources for LG&E Service Company and Mr. Richard Meischeid, Principal of Towers Perrin, the BWG recommendation that the ESTICP be "directly linked" to the ESM should be rejected for sound regulatory reasons.

First, the cost associated with ESTICP is not recovered from LG&E's or KU's customers. The cost of the ESTICP is borne solely by LG&E's and KU's shareholders. The Commission cannot use a ratemaking mechanism like the ESM to determine the disposition of the shareholders' funds. The disposition of such funds is solely the prerogative of the shareholders. The discovery responses show that BWG apparently was not aware of the fact that customers do not pay for the cost of the ESTICP when it made its recommendation. (BWG Response to No. 12). Confronted with this criticism, BWG has simply dismissed it on the grounds that "[i]t does not matter on this issue whether the incentive compensation portion of the executive compensation is allocated to the Companies." (BWG Data Response No. 12). Contrary to BWG's denial, directly linking the results of a ratemaking mechanism to the disposition of shareholder funds does matter. Such action is confiscatory and arbitrary because it allows the regulatory body to dictate how LG&E's and KU's shareholders use their earnings for the nonregulated activities of LG&E Energy Corp.

Secondly, the ESM has a range or a "deadband" of 200 basis points (100 up and 100 down) wherein payment either to or from ratepayers is not required. BWG's recommendation to "directly link" the ESTICP to the ESM ignores the concept of the deadband. Instead, if accepted, it would penalize LG&E and KU executives if the allowed rate of return—which is the midpoint of the 200 basis point dead band range—is not achieved. The BWG Report ignores this fact. Executives would be penalized because they would not have the opportunity to earn the incentive portion of their compensation if the earnings of LG&E or KU remained within the deadband, but below the allowed return. BWG conceded this flaw when it subsequently changed its position in its discovery responses and stated that executives could be rewarded when the Companies' returns were "in or above the deadband each year." (BWG Response Nos. 12, 13, and 15).

Third, BWG's recommendation is inconsistent with BWG's recommendation that the ESM be modified to be a three-year consolidated ESM. BWG recommends a change to the Companies' ***short-term*** incentive compensation while concurrently recommending adoption of a *three-year* cumulative ESM. Thus, BWG's proposed changes to short-term compensation are not synchronized with their proposed change for a longer-term (three-year) period of consideration for the ESM. BWG's Report offers no explanation for this inconsistency. When confronted with this inconsistency, BWG attempt to reconcile its conflicting recommendations by amending its recommendation to state that the long term incentive compensation plan should likewise be directly linked to the results of the three-year cumulative ESM. (BWG Data Response No. 15.) The reasons stated in my testimony, and the testimony of Paula H. Pottinger, Ph.D., Vice President, Human Resources for LG&E Energy Services, Inc. and Mr. Richard Meischeid, Principal of Towers Perrin, for rejecting the BWG recommendation for the short-term incentive plan apply with equal, if not greater, reason to the BWG recommendation for the long-term incentive plan.

Fourth, there is no need for a further "incentive" to force executives to be responsible for achieving the allowed return on equity. The earned ROE is a highly visible statistic for a utility. The earned ROE is perhaps the most widely examined figure for the Companies. To bolster its already weak recommendation, BWG overstates its case when it asserts at page IV-6 of the Report that "[w]hen the allowed rate of return is not achieved, it jeopardizes the utilities' financing capability and short- changes the investors, in this case, E.ON." If the allowed return is within the deadband, it is doubtful that it would jeopardize the financing capability of the Companies. Below the deadband, the ESM tends to act, in the words of BWG, as a "shock absorber". If the earned rate of return was to fall low enough to truly jeopardize the financing capability of the Companies, they would file a new rate case. Thus, penalizing the Companies' executives if the earned rate of return drops below the level of the allowed rate of return in order to protect the finances of the Companies is unnecessary.

Fifth, the recommendation, if adopted, would unfairly penalize LG&E's and KU's management. Regulation is said to give the regulated utility an opportunity, but not a guarantee, to earn its allowed rate of return. However, BWG's recommendation effectively makes the executives guarantee that the Companies will earn the allowed return, penalizing them if they do not. This would be especially unfair if the major determinants of deviations of earned returns from the allowed return were beyond the control of the executives and the Companies. BWG's Report acknowledges determinants affecting the rate of return may be beyond the control of management when it noted the factors which significantly affected ESM results for 2002—and all four of these factors were beyond the control of management. BWG's Report notes at page V-7 that the Companies attributed poor results for 2002 to three factors:

(1) lower margins from off-system sales;

(2) increased transmission (MISO) costs; and

(3) increased pension costs related to poor market performance on plan investments.

In addition, another factor strongly affecting the 2002 results was the decline in interest rates. BWG's Report calculates that lower interest rates reduced the ESM deficit by about $18 million (Report at page I-18). All four of these factors of 2002 results were beyond management's control. The LG&E and KU executives should not be held responsible for the impact of these factors on the earned return on equity.

Incentives should only be applied in situations where management has the capability to strongly influence or control the results. However, the incentives simply become penalties where management is held accountable for results beyond its control, For example, if interest rates over the next several years rise rather than decline, executive compensation is put at risk for the uncontrollable effects of interest rates on the earned return on equity and penalized for this result.

For these reasons, the Commission should reject the recommendation in BWG Report that the Executive Short- and Long-Term Incentive Compensation Plans should be directly linked to the ESM.

CONCLUSION

Q. Do LG&E and KU have a recommendation for the Commission?

A. Yes. The Commission should extend the ESM as proposed by the Companies. The Commission should reject the recommendations of BWG as described in this testimony.

Q. Does this complete your testimony?

A. Yes, it does.

Q. What is your recommendation to the Commission?

A. The Commission should determine whether to extend the ESM and under what terms, and then allow LG&E and KU a reasonable opportunity to decide whether to operate under the extended ESM in the light of the changes, if any, in the terms and conditions for the ESM. The Commission should reject the recommendations of BWG to modify the ESM to become a three-year consolidated ESM and to directly link the Executive Short- and Long-Term Incentive Compensation Plans to the ESM. The adoption of either of these recommendations would give LG&E and KU serious reason to consider not having sufficient incentives to operate under the ESM.

Q. Does this conclude your testimony?

A. Yes.

VERIFICATION

COMMONWEALTH OF KENTUCKY)
)
COUNTY OF JEFFERSON)

The undersigned, **Michael S. Beer**, being duly sworn, deposes and states that he is Vice President, Rates and Regulatory for LG&E Energy Services Inc., that he has personal knowledge of the matters set forth in the foregoing testimony and exhibits, and the answers contained therein are true and correct to the best of his information, knowledge and belief.

MICHAEL S. BEER

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 15th day of October, 2003.

Tammy J. Elzy (SEAL)
Notary Public

My Commission Expires:

TAMMY J. ELZY
NOTARY PUBLIC
STATE AT LARGE
KENTUCKY
My Commission Expires Nov. 9, 2006

EXHIBIT A

MICHAEL S. BEER
LG&E Energy Corp.
200 West Main Street
Louisville, Kentucky

EDUCATION:

THE JOHN MARSHALL LAW SCHOOL, Chicago, Illinois
Juris Doctor, with Distinction - June 1987
Law Review, 1985-87; published Comment, Title VII Today: The Shift Away From Equality, 20 J. Mar. L. Rev. 525 (Spring, 1987)
Order of John Marshall
Admitted to Illinois Bar, 1987

ILLINOIS WESLEYAN UNIVERSITY, Bloomington, Illinois
B.A., Business Administration - May 1980

CARLETON COLLEGE, Northfield, Minnesota
Attended 1976-77 academic year

LEGAL EXPERIENCE:

LG&E ENERGY CORP., Louisville, Kentucky
Vice President, Rates and Regulatory Affairs, February 2001 – Present.
Senior Counsel Specialist-Regulatory, February 2000 – February 2001.
Senior Corporate Attorney, February 1998 – February 2000.

ILLINOIS POWER COMPANY, Decatur, Illinois
Director, Federal Regulatory Affairs, February 1997 - January 1998.
Senior Attorney, August 1995 - February 1997.
Attorney, January 1992 - August 1995.

SOYLAND POWER COOPERATIVE, INC., Decatur, Illinois
Attorney, July 1988 - December 1991.
Contract Buyer, March 1982 - July 1984.

SAMUELS, MILLER, SCHROEDER, JACKSON & SLY, Decatur, Illinois
Associate, August 1987 - July 1988.

BEERMAN, SWERDLOVE, WOLOSHIN, BAREZKY & BERKSON, Chicago, Illinois
Law Clerk/Summer Associate, June 1985 - June 1987.

FACULTY POSITIONS:

MILLIKIN UNIVERSITY, Decatur, Illinois
Adjunct Associate Professor of Business Law, January 1996 - December 1998.
Adjunct Assistant Professor of Business Law, August 1988 - December 1995.

PROFESSIONAL PRESENTATIONS:

United States Energy Law and Practice
Sponsored by the United States Energy Association
October 17-20, Zaporozhye, Ukraine

Utility Restructuring: Negotiating, Structuring and Documenting the Deal
Sponsored by the Practicing Law Institute and the Federal Energy Bar Association.
October 14-15, 1999, New York, NY
Presentation titled: Utility Restructuring and Power Marketing: Keep Your Eye On The Ball.

Utility Restructuring: Negotiating, Structuring and Documenting the Deal
Sponsored by the Practicing Law Institute and the Federal Energy Bar Association.
October 29-30, 1998, New York, NY
Presentation titled: What Is A Power Marketer and How Does This Thing Work?

ABA/IPT Advanced Sales/Use Tax Seminar
Sponsored by the American Bar Association and the Institute for Professionals in Taxation.
March 26, 1998, New Orleans, LA
Presentation titled: Electric Industry Restructuring

IPT International Annual Meeting
Sponsored by the Institute for Professionals in Taxation.
September 29, 1997, Dallas, TX
Presentation titled: Electric Industry Restructuring: An Excise In Utility.

EEI Transmission Subject Area Committee
Sponsored by the Edison Electric Institute.
September 23, 1997, Rapid City, SD
Presentation titled: Retail Access: Experiences and Issues.